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Taking a reality check

Despite negative news from the eurozone, investors can benefit from its continuing recovery

By Stefan Kreuzkamp

LIKE it or not, we live in a world where simple news images can shape investor perceptions. Europe has provided some striking images in recent years, often negative – be they of trouble on the streets of Athens or, more recently, migrants seeking sanctuary. For investors outside Europe, such images can be disconcerting.

But, as a European living in Europe, I know that the reality is rather better than such images might suggest. Europe remains a rich region with considerable underlying business and technological strengths – the export successes of Germany's Mittelstand companies being one obvious example, but there are many others too.

Europe's economic recovery after a difficult few years is also more advanced than most appreciate. A weak euro during much of 2015 has helped boost eurozone exports and corporate profitability. But it is not just the external sector that is doing well: European domestic demand has been getting back on its feet too. Improving consumer confidence has played a part here; higher household credit levels reflect both this improving confidence and continued policy support.

Within Europe, what is particularly interesting is that the southern periphery – so battered by the euro sovereign bond crisis in 2011 and 2012 – is now benefiting most from low bond yields and is showing particular strength in domestic demand. Remarkably, Italian and Spanish consumer confidence indices are already at higher levels than in 2007.

What lies behind this recovery and is it sustainable? It would be foolish to suggest that all of Europe's problems are close to being resolved. The refugee situation will create economic and political strains, many European countries' debt levels remain uncomfortably high and unemployment – at an aggregate rate of over 11 per cent – is still at an unacceptable level.

But there are other signs that a corner has indeed been turned. For several years, tough but necessary fiscal tightening has held back growth in many European economies. Now, this so-called "fiscal drag" is moderating and economic growth is starting to respond. The additional tailwind provided by a weak euro is currently augmented by low oil prices – of benefit to both European corporates and consumers.

As importantly, the European Central Bank (ECB) has shown its mettle. Having been initially slow to move during the financial crisis, the ECB appears increasingly committed to its quantitative easing (QE) programme, first launched in March 2015. We think that an announcement on the lengthening or deepening of the programme – which is at present scheduled to end in September 2016 – could come soon. In addition, further rate cuts – which would take the ECB deposit rate from -0.2 per cent currently to an even more negative level – are under consideration.

Altogether, this should provide some reassurance that, while emerging market growth concerns – and, in particular, slower growth in China – could have an impact on European sectors and individual firms, the domestic fundamentals underpinning European equities are relatively good.

European equity indices followed US indices down in late August and then took a knock from the start of the Volkswagen scandal in September. But European price/earnings ratios remain at attractive levels relative to developed markets overall. The European Q2 earnings season was good and Q3 should have shown further gains. At a country level, German valuations are attractive versus the rest of Europe and existing dividend levels of around 3 per cent offer a floor for investors.

For a fixed income investor, German government bonds look likely to trade in a given range and we stay neutral here. However, eurozone periphery bonds should get support from likely additional ECB QE, so could offer some opportunities. Within corporate debt, European high yield has done well recently, but current valuations levels still seem attractive, given expected low default levels in most areas. And, across both equities and fixed income, longer-term investment opportunities will present themselves as the European economy continues to recover.

Any prospective investor in Europe must consider currency issues. Euro weakness for much of 2015 was temporarily reversed in August and September with an unexpected period of relative dollar weakness. Much will depend here on the expectations of central bank policy and while it is difficult to predict when the Fed will move, it is easier to say with conviction that the ECB will remain dovish – recently, hints of further quantitative easing have pushed down the value of the euro and is likely to continue to do so in future.

Don't expect difficult images of Europe to disappear from your TV screens. But, as investors, we need to look through the headlines and anticipate what is going to happen next. And, as I have argued above, I believe that Europe is likely to offer some major opportunities over the coming year. W

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